Food, Agricultural and Resource Economics
OAC UNIVERSITY of GUELPH

Commodity Price Volatility: The Impact of Commodity Index Traders

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The "Silent Tsunami"

- 2006-2010 – boom and bust cycle for some agricultural commodities.
- Concern- skyrocketing prices in both energy and food markets.
- Policy debate whether commodity index funds were the PRIMARY cause for a rise in energy and food prices and volatilities.

Do farmer benefit?

Yes: Higher average commodity prices.

No: Higher production cost.

No: Higher volatility costs of price risk management for farmers.

The New York Times

A Drought in Australia, a Global Shortage of Rice

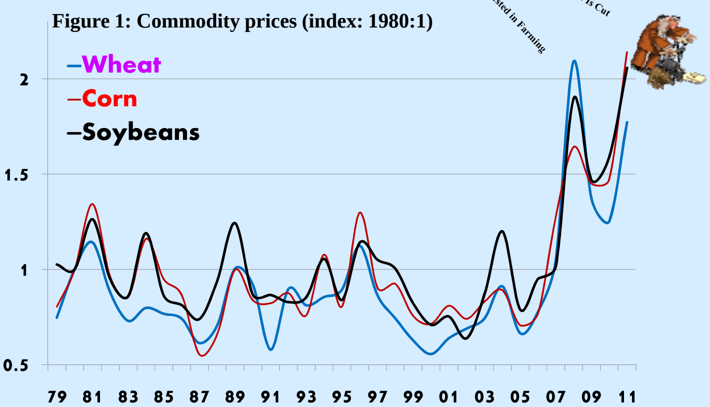
A Global Need for Grain That Farms Can't Fill

Price Volatility Adds to Worry on U.S. Farms

World's Poor Pay Price as Crop Research Is Cut

Food Is Gold, So Billions Invested in Farming

Figure 1: Commodity prices (index: 1980:1)



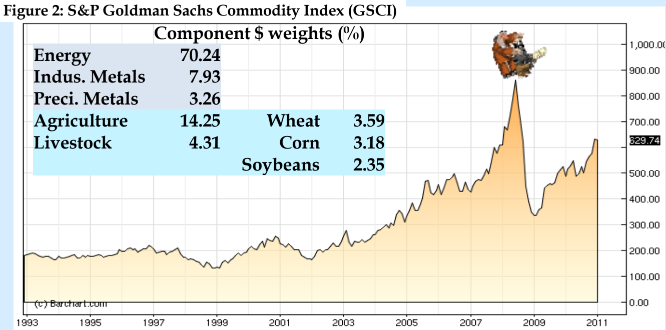
Why the Dramatic Change in Prices?

1. Demand shock - world GDP growth.
2. Supply shock.
3. Lagging public research support.
3. Flow of index funds into commodity indices.

How do commodity index traders operate?

A world production weighted composite index in commodity futures (e.g., Goldman Sachs Commodity Index – GSCI)

Figure 2: S&P Goldman Sachs Commodity Index (GSCI)

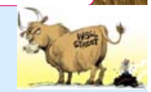


Component $ weights (%)

Energy	70.24		
Indus. Metals	7.93		
Preci. Metals	3.26		
Agriculture	14.25	Wheat	3.59
Livestock	4.31	Corn	3.18
		Soybeans	2.35

Did Index funds influence commodity markets?

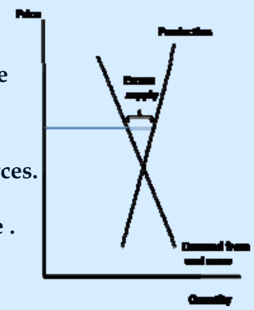
Masters' Argument



1. Demand shock from a new category of participant in the commodity futures markets.
2. These institutional investors hoarded commodities through the futures market.
3. Revolving long position puts pressure on prices
4. Index commodity funds are passive investors.

Counter arguments to Masters

1. Index funds are not consuming the physical product.
2. New demand for futures contracts can be met by new supply.
3. Passive investment stabilizes market forces.
4. Commodity index trading is predictable .



The empirical evidence is inconclusive

Positive relationship between speculative activity and agricultural commodity futures prices (Robles, at al. 2009).

The 2008 oil price was a speculative bubble (Eckaus 2008; Roubini 2009).

There is weak evidence supporting the idea that that index investment contributed to the recent commodity price boom (Gilbert 2009).

Inventories of agricultural commodities declined (Krugman, 2008).

No link between commodity index activity and commodity futures prices (Sanders and Irwin 2009).

Policy Response –It depends

Demand /supply shock: Investment in productivity-enhancing technologies.

Speculation shock: Regulations.

Research in progress…

1. Is there a relationship between commodity price volatility and volume of trade flow?
2. What is the effect of interim price volatility on risk management?
3. Commodity price volatility, poverty and food security.

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